The U.S. Taxation of Scholarships and Fellowship Grants

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The current rules for taxing scholarships and fellowship grants were introduced as amendments to section 117 of the Internal Revenue Code (the "Code") by the Tax Reform Act of 1986 (the '86 Act) relating to excludable scholarship and fellowship grants. Prior to the amendments, the amount of a scholarship or fellowship (even for travel, equipment, clerical help, and incidentals) was excluded from income if the recipient was a candidate for a degree. If the recipient was a not a degree candidate, the grant exclusion was limited to $300 times the number of months covered by the grant, not to exceed 36 months.

The purpose of this paper is to describe the history of the current rules for taxing scholarships and fellowship grants, in both a domestic and international context, so that Congress understands the application of the rules as written and can decide whether they should be reformed.

The 1986 Act Rules

Section 117 as amended defines scholarship and fellowship grants as amounts paid to, or on behalf of, an individual to assist them with their study or research, provided the amounts do not constitute wages for the purpose of section 3401(a) of the Code. The IRS also includes training in the definition as long as the payments for training do not constitute wages. The IRS issued proposed regulations (LR-3-87) under section 117 on June 9, 1988, which have yet to be finalized. The IRS also issued Proposed Reg. section 1.6941-3(q) on June 9, 1988 but withdrew it by IL-062-90 on April 17, 1996. For a complete description of the taxation of scholarships and fellowship grants including a helpful chart of taxable and nontaxable amounts see IRS Publication 970, *Tax Benefits for Education*.

The new rules were part of the base-broadening tax reforms introduced by the '86 Act. As a result of these tax reforms, some scholarship and fellowship amounts that previously had not been taxed became subject to tax. Immediately following the implementation of these new tax rules, however, the IRS issued Notice 87-31, 1987-1 C.B. 475 stating that, unless a scholarship and fellowship grant constitutes wages under section 117(c), the payer is not required under section 6041 to file an information return with respect to such grants. Instead the Notice states:

> The recipient of the scholarship or fellowship grant is responsible for determining whether the scholarship, in whole or part, is includable in gross income under section 117. In other words, the recipient is responsible for determining whether such grant was used for qualified tuition and related expenses. However, to assist students in understanding their federal tax liabilities, it is recommended that the grantor formally advise the recipient in writing that amounts . . . are taxable income, if the aggregate scholarship or fellowship amounts received by the recipient exceed tuition and fees (not including room and board) required for enrollment or attendance at the educational institution and fees, books, supplies, and equipment required for courses of instruction.

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The Notice applies only to scholarship and fellowship grant recipients who are either U.S. citizens or foreign nationals who are resident aliens for U.S. income tax purposes. (The rules defining the tax residency status of foreign nationals are in section 7701(b) and the regulations under that section.)

The IRS was unable to include nonresident alien recipients in the exemption from information reporting because that would have required that Congress amend section 1441 of Chapter 3 the Code (referred to as "NRA withholding"). Section 1441 requires payers who make scholarship and fellowship payments to, or on behalf of, nonresident alien recipients to withhold on these payments.

The 1986 Act Impact on Nonresident Aliens

As a result of the'86 Act rules, scholarships and fellowship grants of nonresident alien students and scholars that had been exempt from tax became subject to both U.S. income tax and NRA withholding. Recipients in F, J, M, or Q immigration status are subject to NRA withholding at a 14 percent rate. Recipients in other immigration categories are subject to withholding at a 30 percent rate. Because the tax rules for defining tax residency status include special rules for foreign nationals in F, J, M, or Q status, most foreign students and scholars who are in these categories are nonresident aliens for U.S. income tax purposes.

These taxable scholarships and fellowship grants include travel reimbursements called "travel funds" or "travel grants." Because such grants are not related to services for employment or self-employment being provided to the payer, these amounts may not be excluded from income under an accountable plan. These nonservice-related travel reimbursements are, therefore, subject to withholding at either a 14 percent or 30 percent rate depending on the immigration category of the recipient. Many of these travel grants are provided by U.S. government agencies such as the Department of State which routinely gives out misinformation about the taxation of such grants.

At the time of the '86 Act, all U.S.-source scholarship and fellowship amounts, including qualified (i.e., nontaxable) amounts, were required to be reported on a Form 1042-S information return. The requirement to report qualified amounts was eliminated by revised regulations under section 1441 that became effective for tax year 2001. The regulations provide that payments excluded from income under the Code are not subject to withholding under section 1441 or reporting under section 1461 of the Code.

Although U.S. citizen and resident alien recipients of scholarships and fellowship grants are subject to tax on their worldwide income, nonresident alien recipients are subject to U.S. income tax and withholding only on their U.S.-source income. At the time of the '86 Act, the source of income for scholarship and fellowship grants was based on where the activities related to the grant occurred. The IRS issued Rev. Rul. 89-67, (1989-1 C.B. 233) which changed the source rule for scholarships and fellowship grants to the residence of the grantor. Because U.S. grantors were giving grants to foreign nationals for study abroad, this ruling resulting in an outpouring of letters from prestigious universities to the IRS protesting the taxation of these grants. As a result, the IRS modified this rule a few years later with Treas. Reg. section 1.863-6 defining scholarship and fellowship grants (and certain achievement grants) as foreign-source if the activities related to such grants occur outside the United States. Because of IRS enforcement of the withholding and reporting on payments to nonresident aliens, the exemptions from tax and withholding (called "treaty benefits") allowed by income tax treaties became important for foreign national recipients of taxable scholarships and fellowships and their U.S. payers. In 1996, educational and other tax-exempt institutions began implementing software programs (designed

by the author) to assist them with withholding and reporting procedures, including treaty analyses for payments to nonresident alien recipients.

In the 1990s, Treasury began to negotiate replacement tax treaties with existing tax treaty partners and tax treaties with new treaty partners. It has been long-standing Treasury policy not to provide benefits for students and trainees particularly in treaties with developed countries. As a result, the new treaties generally do not provide a tax-treaty benefit for taxable scholarships and fellowships grants paid by U.S. residents. The replacement treaties with Austria, Belgium, Denmark, Ireland, Japan, Luxembourg, Sweden, Switzerland, and the United Kingdom have no benefit for scholarship and fellowship grants paid by U.S. residents. (Scholarships and fellowships generally are not subject to income tax in other countries.)

The 2006 U.S. Model Treaty used by Treasury as the starting point for negotiations of new treaties also has no benefit for scholarship and fellowship grants but does include a $9,000 compensation benefit for students and trainees. As a result, the treaties that came into force with Belgium, Bulgaria, and Malta have no benefit for scholarship and fellowship grants paid by U.S. residents. Curiously, the U.S. Competent Authority entered into agreements with both Austria and Belgium to allow research fellowships to be exempt from tax under the Other Income Article of the treaties provided the recipient otherwise meets the conditions for such benefit, specifically continuing tax residency in the treaty country and nonresident alien status in the United States. (Many foreign national researcher scholars become U.S. resident aliens because of the impact of their prior visits to the United States in F or J status on their U.S. tax residency determination.)

IRS Enforcement Activities

The IRS encouraged compliance with the rules for U.S.-source income payments to nonresident aliens with audit of educational institutions that began in the early 1990s. There has been generally no enforcement related to taxable scholarship and fellowship grants paid to, or on behalf of, U.S. citizens and resident aliens. In fact, more than 25 years after the ’86 Act became law Form 1040 still does not include an income line for taxable scholarships and fellowships (taxpayers are instructed to record them on the wages line and write, “SCH” on the dotted line). The result of not requiring the reporting of taxable scholarship and fellowship grants paid to, or on behalf of, U.S. citizens and resident alien recipients was initially general noncompliance with their tax obligations (an unmentioned part of the tax gap). U.S. citizen and resident alien recipients had a de facto “tax benefit” from the non-reporting of their grants with the result that possibly 80 percent or more of taxable scholarships and fellowship grants were not recorded on a U.S. tax return. In the late 1990s, U.S. citizens who used the services of reputable tax preparers began to report their taxable scholarships. Their preparers were alerted to tax issues related to scholarships and fellowship grants when educational institutions began to issue Form 1098-T for purposes of verifying eligibility for education tax credits.

There has generally been much more compliance by nonresident alien recipients of taxable grants, because of the withholding and reporting required by payers of such grants and their potential penalties for noncompliance. The Form 1040NR and 1040NR-EZ nonresident alien tax returns both have specific lines for taxable scholarship and fellowship grants. These nonresident alien recipients have more difficulty in complying with their tax return obligations, however. Because they generally are not authorized to work in the United States, these recipients may not apply for a Social Security number. As a result, they must apply to the IRS for a pre-tax return individual taxpayer identification number (ITIN) for a treaty-exemption from withholding or with their Form 1040NR or 1040NR-EZ tax return. The new

documentation requirements for applying for an ITIN are difficult (if not impossible for those who have returned home) to comply with.

Summary

Congress needs to decide whether scholarships and fellowship grants should be taxed or not, and the impact that their decision will have on the incentive (or lack thereof) for both U.S. citizens and foreign nationals to study or engage in research in the United States.